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Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

October Term 1991

LESTER H. KRABBENHOFT AND
ANNA KRABBENHOFT,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Eighth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Did the safe harbor interest rate of § 483 of the Internal Revenue Code as it read in June, 1981, apply for federal gift tax purposes to preclude imputation of interest where real property was sold by a father to his sons through an installment contract with an interest rate equal to the safe harbor rate?

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OPINIONS BELOW

The May 16, 1991 Opinion of the Court of Appeals, whose Judgment is herein sought to be reviewed, is reported at *Krabbenhoft v. Commissioner of Internal Revenue*, 939 F.2d 529 (8th Cir. 1991) and is reprinted in the appendix to this Petition, p. 1a. Prior opinion of the United States Tax Court is reported at *Krabbenhoft v. Commissioner*, 94 T.C. 887 (1990) and is reprinted in the appendix to this Petition, p. 16a.

JURISDICTIONAL STATEMENT

The Judgment of the Court of Appeals was entered May 16, 1991. On August 9, 1991 the Court of Appeals entered its Order Denying a Petition for Rehearing. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTE AND REGULATION INVOLVED

This case involves I.R.C. § 483 (1976), which is reprinted in the appendix to this Petition, p. 26a. This case also involves Treas. Reg. § 1.483-1(a)(1) (1975), which is reprinted in the appendix to this Petition, p. 29a.

STATEMENT OF THE CASE

This case began with a Petition to the U.S. Tax Court for a redetermination of estate tax deficiencies pursuant

to I.R.C. § 6213(a). Following an adverse determination by the Tax Court, the Petitioners appealed to the Eighth Circuit Court of Appeals pursuant to I.R.C. § 7482(a).

Petitioners, Lester H. Krabbenhoft and Anna Krabbenhoft, ("Krabbenhoft") resided at Sabin, Minnesota, on the day they filed their Petition with the Tax Court. The Krabbenhofts have two sons, Dennis Krabbenhoft and Ralph Krabbenhoft. On June 29, 1981, Krabbenhofts gifted two quarter sections of land to Dennis and Ralph (Parcel A). The fair market value of Parcel A on that date was $400,000. *Krabbenhoft*, 94 T.C. at 888, App. p. 17a.

On June 29, 1981, Krabbenhofts also entered into a Contract for Deed wherein they transferred approximately two other quarters to Dennis and Ralph (Parcel B). The Contract for Deed provided for a purchase price of $400,000 with an interest rate of six percent (6%) payable in 30 equal annual installments of $29,060 commencing in June of 1982. *Id.*

Krabbenhofts filed Federal Gift Tax Returns for the calendar quarter ended June 30, 1981. Separate statutory notices of deficiency were issued to them on May 11, 1987, which claimed an increase in the taxable gifts made by each of them in the amount of $116,940, resulting in a deficiency and gift taxes of $26,444 to each Petitioner. *Id.* at 887-888, App. pp. 16a-17a.

In the deficiency notices, the Commissioner proposed that the Contract for Deed used to purchase Parcel B had a present value of $252,642 and that the value of Parcel B was $443,400 (the later value was corrected by Stipulation to $404,000). The Commissioner used an interest rate of eleven percent (11%) to discount the payments on the

contract to determine present value and asserted that the difference between the present value and the fair market value of the property was a gift made by Krabbenhofts to their sons. *Id.*

On August 7, 1987, Krabbenhofts filed a Petition with the U. S. Tax Court for redetermination of the deficiencies. Based upon stipulated facts, the case was submitted to the Tax Court on May 15, 1989. In their Petition to the Tax Court, Krabbenhofts argued that I.R.C. § 483 applied for gift tax purposes, and that they could use the § 483 safe harbor rate of interest (6%) in a Contract for Deed without adverse gift tax consequences even if the safe harbor rate was below market rate. The Commissioner took the position that, despite the language of the statute "[f]or purposes of this *title*", the section had no application to the gift tax provisions of the Code. *Id.* at 889 (emphasis added) App. pp. 19a-20a.

In a case with almost identical facts, the Seventh Circuit held that § 483 did apply for gift tax purposes, and a taxpayer who complied with the § 483 safe harbor rate in an installment contract could not be subject to gift tax if the safe harbor rate is below the market rate. *Ballard v. Commissioner,* 854 F.2d 185 (7th Cir. 1989). Despite the decision of the Seventh Circuit in *Ballard,* the Tax Court in this case held that the § 483 safe harbor interest rate does not apply to the valuation of a contract for purposes of determining gift tax liability, finding that the Tax Court was not bound by the holding of the Seventh Circuit in *Ballard. Krabbenhoft,* 94 T.C. at 890.

On appeal, a three member panel of the Eighth Circuit Court of Appeals upheld the Tax Court decision.

Krabbenhoft, 939 F.2d at 529. The majority of the three Judge panel rejected the *Ballard* analysis and adopted the reasoning of the Tax Court that § 483 has no application for gift tax purposes. *Id.* at 532. Judge Henley, joined in the decision but noted that his concurrence "is reluctant". *Id.* at 534. Judge Henley's concurrence points to a number of reasons why the issue is not clear, but he declined to resolve the ambiguities in favor of the taxpayer.

Petitioners filed a Petition for Rehearing on July 9, 1991. That request was denied on August 9, 1991 by the Eighth Circuit by reason of the lack of a majority of the active Judges voting to rehear the case. App. p. 25a.

REASONS FOR GRANTING THE WRIT

I. CERTIORARI SHOULD BE GRANTED TO RESOLVE A CONFLICT IN THE CIRCUITS.

One of the reasons frequently expressed for granting a Petition for Certiorari is that a Federal Court of Appeals has rendered a decision in conflict with the decision of another Federal Court of Appeals on the same matter. *See, National Association of Greeting Card Publishers v. U.S. Postal Service*, 462 U.S. 810 (1983); *see also, United States v. O'Malley*, 383 U.S. 627 (1966) (where the United States Supreme Court granted certiorari because of conflicting decisions of Courts of Appeals as to whether a portion of trust principal representing accumulated income was to be excluded from decedent's taxable estate). The decision of the Court of Appeals in this case is in direct conflict with the decision of the Seventh Circuit Court of Appeals in *Ballard* on the identical issue.

In addition, it has been held that granting certiorari is appropriate to resolve conflicting views between Courts of Appeal and the Tax Court. *See United States v. Gilmore*, 372 U.S. 39 (1963). Again, because of the conflict between the Court of Appeals decision in this case and *Ballard*, a conflict of views has arisen between the Courts of Appeals and the Tax Court.[1]

Although the Eighth Circuit decision in this case directly conflicts with that of the Seventh Circuit in *Ballard*, the facts in both cases are remarkably similar. In *Ballard*, the taxpayer sold real property to her children by way of a contract for deed using the § 483 safe harbor interest rate of 6% per annum. Like the Krabbenhofts in this case, Mrs. Ballard filed a gift tax return reporting a gift, the taxes on which did not exceed the tax credit to which Petitioner was entitled. Following the filing of the gift tax return, the Commissioner issued Mrs. Ballard a Notice of Deficiency of Gift Tax based on the Commissioner's discounted value of the consideration Petitioner was to receive under the contract as opposed to the market value of the property. The Commissioner utilized the exact same method in assessing the deficiency against Krabbenhofts in the present case.

The narrow issue determined in both the present case and *Ballard* is the same. Essentially, the question is whether or not § 483 of the Internal Revenue Code as it read in June of 1981 provided a "safe harbor" interest rate

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[1] *Compare Ballard*, 854 F.2d 185, *and Cohen v. Commissioner*, 92 T.C. 1039 (1989), *with Krabbenhoft*, 94 T.C. 887 *and Krabbenhoft*, 939 F.2d 529 (the present case).

on an installment land sale contract without either income *or gift* tax consequences.

At the Tax Court and Appellate levels in *Ballard*, the Commissioner argued that the language in § 483, "for purposes of this title", really meant "for purposes of this *sub*title" (income tax), given the legislative history of § 483 and the sections placement in the income tax part of the Code. *Ballard*, 854 F.2d at 186 (emphasis added). In the present case, the Commissioner made the same argument in a slightly different manner. Instead of arguing that the language in § 483 was only meant to apply to the income tax subtitle, the Commissioner argued that § 483 applied only to sections of the Code to "which it is relevant". *Krabbenhoft*, 939 F.2d at 532. This argument was embraced by the Eighth Circuit. *Id.*

Although couched in different terms, the argument is the same in both instances. Essentially, the Eighth Circuit in the present case accepted the Commissioner's argument that, despite the language of § 483 that it applies for "puposes"[2] of the Code, it applies for only one purpose, i.e., to recharacterize payments as principal or interest for *income* tax. Thus, despite the Eighth Circuit's comment that the decision in *Ballard* resulted from a specious argument made by counsel for the Commissioner, *Krabbenhoft*, 939 F.2d at 532, it appears that the issues and arguments presented in both cases were the same.

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[2] Interestingly enough, the Commissioner's own regulation indicated that § 483 was to apply "[f]or *all* purposes of the Internal Revenue Code . . . ". Treas. Reg. § 1.483-1(a)(1) (1975) (emphasis added).

The Appeals Court in this case also criticized the Seventh Circuit in *Ballard* for coming to its conclusion "without much analysis" *Krabbenhoft*, 939 F.2d at 532. A review of the Eighth Circuit's opinion in this case, however, shows that the Eighth Circuit failed to consider the *Ballard* Court's analysis of subsequent legislation which supports the *Ballard* Court's conclusion, and which was presented to the Eighth Circuit by the Petitioners in this case. With the exception of Judge Henley's concurrence (which failed to grasp the true meaning of the subsequent legislation), the Eighth Circuit's opinion ignored Petitioner's argument in that regard.

Essentially, the subsequent legislation shows Congress had assumed the § 483 safe harbor rate applied to gift tax valuation. Specifically, § 483 has been amended several times, but each time Congress has retained the prefatory language – "For purposes of this title . . . ".[3] There has been no change indicating § 483 is to apply only to income tax.

Furthermore, in response to the Secretary of the Treasury's announcement that the safe harbor rate was being raised from six percent to nine percent in July of 1981, Congress added § 483(g), which retained a lower safe harbor rate for some sales of land between related parties. *See* Pub. L. No. 97-34, § 126, 95 Stat. 172, 202 (1981). Comments made by Senators regarding that legislation indicate Congress intended to *maintain* a safe harbor rate

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[3] *Compare* I.R.C. § 483(a) (Supp. III 1985) *with* I.R.C. § 483(a) (Supp. II 1984) *and* I.R.C. § 483(a) (1982) *and* I.R.C. § 483(a) (1976).

for purposes other than income tax. For example, Senator Jepson made the following comments:

> When the time comes for a child to get started in business or farming, he or she cannot afford 20-percent interest rates and the enormous capital expenditures. So, a father and mother give the child a break: A low interest loan and a deferred payment schedule. This does two things: It helps the young person when such help is critical and allows parents to pass on their property to their offspring without incurring the confiscatory rate of present estate taxation. Raising the imputed interest rates will effectively close off that option to many farmers and businessman.

127 Cong. Rec. 17806 (1981).

In such a context, it would be illogical for Congress to intend that the safe harbor rate of § 483 would relieve adverse income tax and estate tax consequences, but not relieve adverse gift tax consequences.

Finally, in response to the holding in *Dickman v. Commissioner*, 465 U.S. 330 (1984), that interest free loans between family members may result in taxable gifts, Congress enacted I.R.C. § 7872. In general, § 7872 sets forth both the income and gift tax rules for loans which are made at below market interest rates, and provides a safe harbor interest rate provision. Specifically exempted from § 7872, however, is any transaction to which § 483 applies. *See* I.R.C. § 7872(f)((8) (Supp. III 1985). By specifically exempting § 483 transactions, Congress was acknowledging that § 483 provides its own safe harbor interest rate for gift tax valuation for below market rate

installment contracts which obviates the need for application of the § 7872 safe harbor rate. Any other construction would allow taxpayers to escape a gift tax problem by giving a loan at the § 7872 safe harbor rate, but trigger a gift where an installment sale using the § 483 safe harbor rate was used. Such a result would not only be inequitable, but it would be irrational.

II. CERTIORARI SHOULD BE GRANTED BECAUSE THE EIGHTH CIRCUIT'S DECISION IS CONTRARY TO ESTABLISHED PRINCIPLES OF STATUTORY CONSTRUCTION.

In order to reach the decision in this case, the Eighth Circuit overlooked precedent that resort to legislative history is not required where a statute is clear on its face. *Ballard*, 854 F.2d at 185. Because the Court in *Ballard* found the language of § 483 to be plain and unambiguous, it was unnecessary to resort to the legislative history. On the other hand, the Eighth Circuit looked first to the legislative history to determine that the general reason for the statute was an income tax problem, not a gift tax valuation problem. *Krabbenhoft*, 939 F.2d at 531. With this history as a backdrop, the Eighth Circuit then looked to § 483 to see if it contained any language directed specifically at gift taxes. *Id.* at 532. Finding none, the Court held § 483 was not relevant to gift tax valuation. It is the *Ballard* Court's approach, however, which follows the proper rules of statutory construction.

Even if, as Judge Henley's concurrence suggests, the language of § 483 is ambiguous, the *Ballard* analysis is still correct. Where such ambiguities exist, it is appropriate that all doubts be resolved in favor of the taxpayer

and against the Government. *See*, e.g., *Ransberg Corp. v. Commissioner*, 621 F.2d 264 (7th Cir. 1980). In the present case, however, the Court of Appeals, while expressing sympathy for the Krabbenhoft's plight, resolved all doubt in favor of the Commissioner ignoring precedent to the contrary.

III. CERTIORARI SHOULD BE GRANTED BECAUSE THE DECISION AFFECTS A TAX RULE OF NATIONAL APPLICATION IN WHICH THERE IS A NEED FOR NATIONAL UNIFORMITY.

In declining to follow the decision in *Ballard*, the Tax Court in this case claimed it was not bound by *Ballard* because *Ballard* was decided by the Seventh Circuit, whereas this case would be appealed to the Eighth Circuit. Indeed, in this case, the *only* difference between the present case and *Ballard* appears to be the residence of the Petitioners. Although such a course may be correct as a matter of law, there is no good policy reason for applying tax rules differently depending on the residence of the taxpayer.

The Eighth Circuit suggested that the scenario presented by this case was unlikely to occur with frequency. *Krabbenhoft*, 939 F.2d at 535 (Henley, J., concurring). The Court came to this conclusion because of the high interest rates which existed at the time of the Contract for Deed in question, and because of the Court's belief that the tax laws now provide for a safe harbor rate for gift tax purposes. *Id.*

The fact of the matter is, however, that this case is not an isolated occurrence. During the time frame in question, (roughly 1980 through 1984), Contract for Deed financing in Minnesota farm real estate transfers was utilized in 60% of all transactions.[4] During that same time, the *average* seller financed interest rate on farm real estate loans never rose above 10%, although interest rates utilized by other lending institutions were significantly higher. *See*, D. Dion & P. Raup, *The Minnesota Real Estate Market in 1985* (Minnesota Agricultural Economist No. 650 January, 1986). Clearly, a significant number of low interest seller financed real estate transfers occurred in Minnesota between 1980 and 1984. Nationwide, the number would be exponentially higher.

The issue is, therefore, one of substantial national importance for sellers of rural real estate who utilized seller financed transactions during the time frame in question. There is an increased danger of assessment of deficiencies in cases where a taxpayer assumed no gift tax was owed, and did not file a return, because the statute of limitations would not run and a deficiency could be assessed at any time. *See* Note, *The Safe Harbor Interest Rates under § 483 of the Internal Revenue Code: A Gift Tax Trap*, 20 Ind.L.Rev. 679, 687 (1987). Because of interest and penalties associated with assessing a deficiency from ten years ago, the amount due could be staggering.

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[4] Specifically, 60% was the figure for the year 1982. *See* M. Smith & P. Raup, *The Minnesota Rural Real Estate Market in 1982*, University of Minnesota Department of Agriculture and Applied Economics, ER 83-6 (1983).

CONCLUSION

For the above and foregoing reasons, Petitioners pray that this Court grant a Writ of Certiorari to review the decision by the Eighth Circuit Court of Appeals.

Respectfully submitted,

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APPENDIX

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UNITED STATES COURT OF APPEALS

FOR THE EIGHTH CIRCUIT

No. 90-2876

Lester H. Krabbenhoft; Anna Krabbenhoft, Appellants, v. Commissioner of Internal Revenue, Appellee.	*	Appeal from the United States Tax Court

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Submitted: May 16, 1991

Filed: June 27, 1991

Before FAGG, Circuit Judge, HENLEY, Senior Circuit Judge, and MAGILL, Circuit Judge.

MAGILL, Circuit Judge.

Lester and Anna Krabbenhoft appeal the Tax Court's[1] decision affirming the Commissioner's assessment of gift tax liability against each of them. The Krabbenhofts challenge on appeal the Tax Court's determination that 26

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[1] The Honorable Charles E. Clapp, II, Judge, United States Tax Court.

U.S.C. § 483's "safe harbor" interest rate does not apply to the valuation of a contract for purposes of determining gift tax liability, and that court's holding that the interest rate the Commissioner used to value the contract at issue was proper. We affirm.

I.

On June 29, 1981, the Krabbenhofts, Minnesota farmers, transferred land to their sons by means of a contract for deed. The contract provided for a purchase price of $400,000, an interest rate of six percent, and thirty annual payments of $29,060.

On May 11, 1987, the Commissioner issued separate statutory notices of deficiency to the Krabbenhofts; the notices stated that for 1981 each owed $26,444 in gift tax. The deficiency assessment resulted from the Commissioner's having determined that the contract for deed had a 1981 present value of $252,642, although the fair market value of the land was $443,400. The Commissioner classified the $190,758 difference in value as a gift, and assessed gift tax liability accordingly. To determine the 1981 present value of the contract for deed, the Commissioner used an eleven percent interest rate.

The Krabbenhofts petitioned the United States Tax Court for a review of the Commissioner's determination. The Krabbenhofts raised two main challenges to the Commissioner's decision. First, they argued that the Commissioner erred in going behind the face value of the contract for deed to determine its 1981 present value. The Krabbenhofts based this argument on 26 U.S.C. § 483,[2]

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[2] *See infra* Part II.

which they contended entitled them to use the "safe harbor" interest rate provided for in that section, and bound the Commissioner to use the same rate for gift tax valuation purposes. In making this argument, the Krabbenhofts relied in part on the Seventh Circuit's decision in *Ballard v. Commissioner,* 854 F.2d 185 (7th Cir. 1988), where that court overturned a prior Tax Court determination that § 483 did not apply to the valuation of contracts for gift tax purposes.

The Krabbenhofts also argued that even if § 483 did not apply, the Commissioner had incorrectly used an eleven percent interest rate to determine the 1981 present value of the contract for deed. They contended that their six percent rate was consistent with the rates for similar types of transactions at the time.

The Tax Court disagreed with the Krabbenhofts on both points, and upheld the Commissioner's assessment of gift tax liability. *See Krabbenhoft v. Commissioner,* 94 T.C. 887 (1990). The Tax Court concluded that § 483 applied to impute interest rates on installment sales contracts for income tax purposes, and was not relevant to determining value for gift tax purposes. *Id.* at 890. Because the Tax Court believed that *Ballard* was wrongly decided, and because the Krabbenhofts' case would be appealed to this court, and not the Seventh Circuit, the Tax Court expressly refused to follow *Ballard. Id.*

The Tax Court also ruled that the Krabbenhofts did not prove that the Commissioner's use of an eleven percent interest rate was incorrect. *Id.* at 892. The Tax Court thus upheld the Commissioner's assessment, although as a result of certain stipulations the Krabbenhofts' liability

was reduced to $19,568 each. The other members of the Tax Court reviewed the decision: thirteen members of the court agreed with it, two dissented. The Krabbenhofts now appeal.

II.

A. Section 483

The Krabbenhofts first argue that the Tax Court erred in holding that 26 U.S.C. § 483 does not apply to gift tax valuation. At the time of the transaction in question, 26 U.S.C. § 2512 addressed the valuation of gifts. The statute provided:

> (a) If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.
>
> (b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift. . . .

26 U.S.C. § 2512 (1976). The amount of the gift is its fair market value at the time of transfer. *Carpenter v. United States*, 7 Cl. Ct. 732, 736 (1985), *aff'd mem.*, 790 F.2d 91 (Fed. Cir. 1986). To determine the fair market value of an installment sales contract, the Commissioner is entitled to consider a number of factors, including the face value of the contract, its interest rate, the interest rate used in similar transactions, and the length of the contract. *See Blackburn v. Commissioner*, 20 T.C. 204, 207 (1953).

The Krabbenhofts argue that the plain language of § 483 forecloses a determination of fair market value

when an installment sales contract provides for interest in the amount the statute prescribes. At the time of the transaction in this case, § 483 provided, in pertinent part:

> (a) Amount constituting interest
>
> For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.
>
> (b) Total unstated interest
>
> For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of –
>
> (1) the sum of the payments to which this section applies which are due under the contract, over
>
> (2) the sum of the present values of such payments and the present values of any interest payments due under the contract.
>
> For purposes of paragraph (2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary.

26 U.S.C. § 483 (1976).

Before § 483 was enacted, if the parties to an installment sales contract did not provide for interest on the deferred payments, the seller could treat the entire amount received (to the extent that it exceeded the seller's adjusted basis in the property) as capital gain, even though some of the amount likely represented interest. The advantage to this was that capital gain was taxed at a lower rate than interest, which was taxed as ordinary income. After § 483's enactment, if an installment sales contract did not provide for interest, the interest rate from the relevant regulation would be imputed to recharacterize part of the payments as interest. In June 1981, this interest rate was seven percent compounded semi-annually. The regulation also provided, however, that if the contract provided for an interest rate of at least six percent, no higher rate would be imputed to recharacterize any part of the payments as interest. See Treas. Reg. § 1.483-1 (1981), *reprinted in* 1 Federal Tax Regulations 2112-15 (1981).

The Senate Report accompanying the enactment of § 483 stated the general reason for the statute:

> Your committee agrees with the House that there is no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments. In the case of depreciable property this may convert what is in reality ordinary interest income into capital gain to the seller. . . . The House and your committee believe that

> manipulation of the tax laws in such a manner is undesirable and that corrective action is needed.

S. Rep. No. 830, 88th Cong., 2d Sess., § IV.B.29(b), *reprinted in* 1964 U.S. Code Cong. & Admin. News 1673, 1775.

The Krabbenhofts argue that because § 483(a) begins, "For the purposes of this title . . . ", that section applies to the entire Tax Code. We agree. As will be shown, however, that does not help the Krabbenhofts. Reasoning from the premise that § 483 applies to the entire Tax Code, the Krabbenhofts next argue that because § 483 provides that interest will not be imputed to installment sales contracts that feature an interest rate of at least six percent, the use of a six percent interest rate also bars the Commissioner from determining the present value of the contract for purposes of assessing gift tax liability. The flaw in this argument is the assumption that § 483 is relevant to the determination of present value for gift tax purposes. As the Tax Court opined:

> We agree that the prefatory language of section 483 is unambiguous, and that section 483 therefore applies to all sections of the Code to which it is relevant. However, we find nothing in the language of section 483 that indicates that this section has anything to do with valuation. The section merely characterizes payments as principal or interest, while gift tax valuation is concerned with the value of all payments, whether of principal or of interest. The character of a payment does not affect its value for gift tax purposes.

94 T.C. at 890. The Krabbenhofts argue that the Tax Court's statement that § 483 applies to all sections of the

Code to which it is relevant "flies in the face" of our decision in *Robinson v. Commissioner*, 439 F.2d 767 (8th Cir. 1971) (per curiam), where we stated: "Even though § 483 does not specifically refer to [26 U.S.C.] § 453, the former provision is applicable to § 453 because § 483 is couched in the comprehensive and unambiguous language that it is to apply for 'purposes of this title.' " *Id.* at 768. The Krabbenhofts' reliance on *Robinson* is misplaced. In *Robinson*, it was clear that § 483 applied to § 453 because the latter addressed the installment basis of reporting income and the former addressed the recharacterization of parts of installment payments. Therefore, § 483 applied to § 453 *because it was relevant to that section.*

We believe § 483 is not relevant to the gift tax statute, § 2512. The Krabbenhofts place great weight on the broad introductory language of § 483(a), but ignore the simple fact that nothing in § 483 makes it relevant to valuation for gift tax purposes. Section 483 is not a definitional or policy-type statement of wide-ranging applicability, like, for example, "Fair market value means X." If that were the case, then every time "fair market value" appeared in the Tax Code, § 483 would be relevant, and would apply. Rather, § 483 operates to recharacterize certain amounts of installment or deferred payments as interest. The Krabbenhofts cite many cases where § 483 was applied to another provision of the Tax Code. Those cases, however, all involved installment or deferred payments, and thus § 483 was relevant. *See Kingsley v. Commissioner*, 662 F.2d 539, 542-45 (9th Cir. 1981); *Vorbleski v. Commissioner*, 589 F.2d 123, 132-34 (3d Cir. 1978); *Katkin v. Commissioner*, 570 F.2d 139, 142 (6th Cir. 1978); *Solomon v. Commissioner*, 570 F.2d 28, 34-37 (2d Cir. 1977); *Jeffers v. United States*, 556

F.2d 986, 987 (Ct. Cl. 1977); *Cocker v. Commissioner*, 68 T.C. 544, 555 (1977); *Catterall v. Commissioner*, 68 T.C. 413, 419-22 (1977).

The only other pertinent argument that the Krabbenhofts proffer is that we should follow the Seventh Circuit's decision in *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir. 1988). In *Ballard*, the Seventh Circuit first concluded that § 483 applied to the entire Tax Code. *See id.* at 188. On this point we are in complete agreement. The Seventh Circuit next concluded, without much analysis, that § 483 specifically applied to valuation for gift tax purposes. *Id.* at 189; *see also Cohen v. Commissioner*, 910 F.2d 422, 428 (7th Cir. 1990) ("In *Ballard*, this court held that § 483 applied to limit the interest rate which could be used to value the gift which resulted from a below-market installment sales transaction between a mother and her children."). It appears that counsel for the Commissioner was at least partly responsible for this conclusion, having speciously argued that if the taxpayer had used no interest rate, a seven percent rate would have been used for both income and gift tax purposes, but because the taxpayer used the six percent "safe harbor" rate, the Commissioner could use an eighteen percent market rate for gift tax valuation purposes. *Ballard*, 854 F.2d at 189. The Seventh Circuit commented: "Though perhaps well suited for a fairy tale, this sort of logic fails here." *Id.*

In this case, the Commissioner has repudiated the argument his counsel made in *Ballard*, stating that it was contrary to the Commissioner's position at that time as well as now. We thus have no "fairy tale logic" to contend with in this case. Therefore, we conclude that § 483 does

not limit the interest rate the Commissioner can use in valuing an installment sales contract for gift tax purposes because § 483 is simply irrelevant to such a determination.

B. The Valuation Evidence

The Krabbenhofts also argue that even if § 483 is irrelevant to the determination of fair market value, the Tax Court erred in accepting the Commissioner's use of an eleven percent interest rate to compute the 1981 present value of their contract. In selecting an interest rate for use in computing fair market value, the Commissioner may rely on the rate for similar transactions. *See Blackburn*, 20 T.C. at 207. In this case, the Commissioner introduced as evidence the following June 1981 interest rates: the average prime rate was 20.3%; the average interest rate on conventional first mortgage loans for a single family home was 14.12 to 14.40%; and the Minnesota office of the Federal Land Bank's rate was 10.75%. *See* 94 T.C. at 891-92.

In challenging the Commissioner's method of valuation, the Krabbenhofts had the burden of proving that the Commissioner's method was incorrect. *See Carpenter*, 7 Cl. Ct. at 736. To satisfy this burden, the Krabbenhofts attempted to introduce three pieces of evidence. Their first piece of evidence was a Treasury official's response to a question from a Senate subcommittee during 1981 hearings on imputed tax rates and § 483. A subcommittee member asked the official: "Are contracts for deed prevalent in the 6 to 8 percent range or something like that." The official answered: "Right." *See* Joint Appendix at 130.

The Tax Court considered this testimony but did not give it much weight because of its "off-hand nature." 98 T.C. at 891. The Krabbenhofts also sought to introduce testimony at the same hearings from an agricultural economist on the issue of the interest on contract for deed sales in Minnesota. The Tax Court concluded that this material was inadmissible hearsay, and should have been introduced by expert testimony subject to cross-examination to guarantee its trustworthiness. *Id.* Finally, the Krabbenhofts sought to introduce a graph depicting how interest rates on seller-financed real estate were lower than Federal Land Bank rates. The Tax Court excluded this evidence on the basis of relevance, because other factors not present in the Krabbenhofts' situation were apparently included in the calculations supporting the graph. *Id.* Based on the first piece of evidence, the Tax Court concluded that the Krabbenhofts had not proved that the Commissioner's use of an eleven percent interest rate was incorrect.

As an initial matter, we agree with the Tax Court's conclusion as to the graph. The economist's testimony presents a closer question. The Krabbenhofts argue that this testimony was admissible hearsay under Fed. R. Evid. 803(8), which provides for the admissibility of certain official records, reports, and statements. However, the "[a]nalysis of trustworthiness and ultimate determination of admissibility of records, reports, [and] statements . . . is committed to the sound discretion of the trial court," and we will not reverse such a determination unless there has been an abuse of discretion. *See O'Dell v. Hercules, Inc.*, 904 F.2d 1194, 1204 (8th Cir. 1990). On the record in this case, we find no abuse of discretion. Thus,

the only evidence contradicting the Commissioner's use of the eleven percent rate was the Treasury official's casual response at the Senate hearings. We agree with the Tax Court's conclusion that this evidence was insufficient to prove that the Commissioner's rate was incorrect. Therefore, the Tax Court properly held that the Krabbenhofts failed to prove that the Commissioner's use of an eleven percent interest rate to value their contract for deed was incorrect.

III.

Accordingly, we affirm the judgment of the Tax Court.

HENLEY, Senior Circuit Judge, concurring.

With deference to the views of the district court and the views of the majority concerning statutory construction, I feel compelled to concur in the result reached by the panel. My concurrence is reluctant. It is not at all clear to me that Congress wanted or anticipated application of the gift tax to a family transaction like the one consummated by the Krabbenhofts. Congress certainly did not anticipate the runaway interest rates in existence in the early 1980's, including a prime rate of nearly twenty per cent. Although the total tax assessed in this case was just over $50,000.00, with interest for about ten years added on, the actual balance due now is much more than that amount.

Looking at § 483 in isolation and ignoring subsequent legislation, it is possible to conclude the "safe harbor" provision is applicable only to the income tax. In reaching

this technical conclusion, one must accept the proposition that Congress either intended, or else simply failed to consider, the possible "gift tax traps" that would be created any time market rates rose above six per cent. The Krabbenhofts were caught by two of these traps. First, although their transaction was safe from income tax revaluation, it was revalued for gift tax purposes. The other trap that caught the Krabbenhofts resulted from the procedure of permanently determining gift tax on the date of sale. Since market rates were particularly high at that date, their long-term sale was forever valued at a substantial discount.[1] In the real world, taxpayers can refinance their loans, but they cannot have their gift tax later readjusted for changed conditions.

At the time the Krabbenhofts transferred the land, the six per cent rate was the only specific statutory guidance they had. This rate appeared with respect to § 483 transfers, and in Treasury Regulation § 25.2512-9, which is used in valuing life and remainder interests. Historically, six per cent was a reasonable "safe harbor" rate with many loans and home mortgages issued during the 1970's at even lower rates. It was not until about 1980 that rates began to skyrocket.

---

[1] At oral argument, government counsel admitted if an installment sale is made using a variable rate instrument, as long as the rate is tied to an index such that a market rate comparable to the Internal Revenue Service rate is assured, no gift tax revaluation of the transaction would likely occur. This may be the only way, however, for taxpayers consummating long-term installment sales during periods of high interest rates to complete a transaction in a manner that is both affordable for the buyer and safe from gift tax assessment.

Unfortunately, Congress did not get around to dealing with the problem until the 1983-1984 term when it created a uniform market-based system of interest rates. Through §§ 1271-74, Congress enacted a market rate system for different types of loans that is updated periodically through Revenue Procedures. As government's counsel confirmed at oral argument, sections such as 483 and 7872 (low interest or no interest loans), now govern the *gift and income* tax treatment of most loans. Congress also updated the estate and gift tax regulations to provide for a ten per cent interest rate for use in valuing life and remainder interests. The more comprehensive and realistic system of rates in existence now is of no help to the Krabbenhofts, however, because their transaction happened to fall in the legislative and economic "no man's land" between 1980 and 1983.

The plain language of the statute strongly suggests the "safe harbor" provision is only relevant to the income tax. Even if one ignores the plain language and goes beyond the text, the legislative history presented on appeal is simply inadequate for me to conclude with confidence that the tax court and this panel have erred as a matter of law in interpreting § 483. The legislative history presented to us in this case is simply inconclusive as to the scope of § 483. The application of the statute based on the majority's interpretation, though seemingly harsh in this case, has not been argued to be, and the record before us does not clearly demonstrate that it is, in violation of the due process, equal protection or other requirements of the Constitution, though such an argument might well be made in another case.

As for part B of the panel's opinion, I agree that the trial court is in a much better position to evaluate the evidence than are we. It seems to me that the valuation issue is a close one and that other evidence may have been available, though not presented in this case, that would have been sufficient to support the interest rate used by appellant and refute the government's assessment.

Although this may be of small comfort to the Krabbenhofts, my concerns with the issues raised here are somewhat diminished by the hope that relatively few taxpayers will be affected by our decision here today. Not only might another taxpayer be successful on the merits where the Krabbenhofts were not, but only a small percentage of transactions occurring in the early 1980's are likely to be affected. As indicated, I concur in the result reached by the majority of the panel.

A true copy.

Attest:

CLERK, U. S. COURT OF APPEALS,
EIGHTH CIRCUIT.

94 T. C. No. 56

UNITED STATES TAX COURT

LESTER H. KRABBENHOFT AND
ANNA KRABBENHOFT, Petitioners *v.*
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 26561-87. Filed June 19, 1990.

Ps sold land to their sons on June 29, 1981, pursuant to an installment sale agreement, with interest on the remaining balance to be paid at the interest rate set by sec. 1.483-1(d)(1)(ii)(B), Income Tax Regs. R used a higher market interest rate to discount the installment payments in determining the value of the gift on the sale. *Held*, R used the proper interest rate to discount the installment payments as sec. 483 does not apply to gift tax valuation. *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir. 1988), revg. T.C. Memo. 1987-128, not followed on this issue.

Jerry D. Larson, for the petitioners.

John C. Schmittdiel, for the respondent.

JUN 19 1990

OPINION

CLAPP, *Judge*: Respondent determined a $26,444 deficiency in petitioners' Federal gift tax for the calendar quarter ending June 30, 1981. Following concessions, the issues are (1) whether petitioners' sale of land to a family member at the interest rate set by section 1.483-1(d)(1)-(ii)(B), Income Tax Regs., prevents respondent from using a higher market interest rate for gift tax purposes, and (2) if not, whether respondent correctly determined the

amount of the gift. All section references are to the Internal Revenue Code of 1954 for the quarter in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

The case was submitted fully stipulated under Rule 122. Petitioners resided in Sabin, Minnesota when they filed their petition.

On June 29, 1981, petitioners sold farmland worth $404,000 to their sons, Dennis and Ralph Krabbenhoft (the purchasers). The land was sold pursuant to a contract for deed that provided for a purchase price of $400,000, an interest rate of 6 percent, and 30 annual installment payments of $29,060 commencing in June 1982. In the event of the death of either or both petitioners, the purchasers were required to prepay the contract in an amount equal to the state and Federal estate taxes attributable to the inclusion of the contract in petitioners' estates. Respondent used an interest rate of 11 percent to discount the payments on the contract, and concluded that the contract had a present value of $252,642. See *Blackburn v. Commissioner*, 20 T.C. 204, 207 (1953). Respondent asserts that the $151,358 difference between this amount and the $404,000 fair market value of the property was a gift made by petitioners to the purchasers. See sec. 2512(b).

Section 483 provides in relevant part –

> (a) AMOUNT CONSTITUTING INTEREST. – For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which

bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) TOTAL UNSTATED INTEREST. – For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of –

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary. * * *

(c) PAYMENTS TO WHICH SECTION APPLIES. –

(1) IN GENERAL. – Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract –

(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

> (B) under which, using a rate provided by regulations prescribed by the Secretary of purposes of this subparagraph, there is total unstated interest.
>
> Any rate prescribed for determining whether there is total unstated interest for purposes of subparagraph (B) shall be at least one percentage point lower than the rate prescribed for purposes of subsection (b)(2).

The regulation referenced by section 483(c)(1)(B) established a 6-percent interest rate. Sec. 1.4831(d)(1)-(ii)(B), Income Tax Regs. Because the same 6-percent interest rate was used in the contract, the contract for the sale of the property contained no unstated interest. Accordingly, section 483 did not apply to the contract.

Petitioners point out that section 483(a) states that section 483 applies "For purposes of this title * * * ." They therefore argue that since section 483 imputes no interest, respondent may not determine that for gift tax purposes the contractual interest rate was insufficient. We faced the same argument in *Ballard v. Commissioner*, T.C. Memo. 1987-128, revd. 854 F.2d 185 (7th Cir. 1988), which involved similar facts. In that case we held for respondent, saying that –

> manipulation of the tax laws to characterize ordinary interest income as capital gain was the specific problem Congress intended to cure when it enacted section 483. * * *
>
> * * *
>
> proper valuation in gift tax cases looks to fair market value and its notions of a willing buyer and willing seller. Section 483 has nothing to do

> with valuation. The purpose of section 483 is to recharacterize portions of payments on certain installment sales of property as interest payments when not enough interest has been provided for in the installment contract. We are not concerned here with the characterization as ordinary income or capital gain of any installment payments petitioner may receive under that contract in the future. We are concerned with the present value of all the payments she will receive under that contract. From a careful reading of section 483, its regulations, legislative history, and pertinent case law, we cannot find that the interest rates published in the regulations thereunder could or should be relied on for gift tax valuation purposes. [*Ballard v. Commissioner, supra*, 56 P-H Memo T.C. para. 87,128 at 650-651, 53 T.C.M. 325-326 (1987). Fn. ref. omitted.]

Ballard was reversed on appeal by the Seventh Circuit. The instant case would be appealed to the Eighth Circuit, so we are not bound by the holding of the Seventh Circuit. See *Golsen v. Commissioner*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971). We have considered the reasoning of the Seventh Circuit and respectfully decline to follow it.

The Seventh Circuit asserts that the prefatory words "For purposes of this title" in section 483(a) unambiguously indicate that section 483 applies to the entire Code, including the gift tax provisions. The Seventh Circuit additionally believes that contracts which escape the imputed interest provisions of section 483 are within a

"safe harbor" that prevents the recharacterization of principal as interest. The Seventh Circuit accordingly concludes that the principal payments on a contract which falls within the safe harbor may not be recharacterized as interest for purposes of gift tax valuation.

We agree that the prefatory language of section 483 is unambiguous, and that section 483 therefore applies to all sections of the Code to which it is relevant. However, we find nothing in the language of section 483 that indicates that this section has anything to do with valuation. The section merely characterizes payments as principal or interest, while gift tax valuation is concerned with the value of all payments, whether of principal or of interest. The character of a payment does not affect its value for gift tax purposes. Accordingly, we reaffirm our holding in *Ballard* that section 483 has no relevance to gift tax valuation. See *Cohen v. Commissioner*, 92 T.C. 1039, 1051 (1989).

The Seventh Circuit also discusses *Blackburn v.Commissioner*, 20 T.C. 204 (1953), which was decided before the enactment of section 483. The 2-1/4 percent interest charged under the contract in *Blackburn* was below the 4-percent market rate. The Seventh Circuit agrees that in *Blackburn* we properly discounted the principal amount under the contract at the 4-percent rate. The Seventh Circuit concludes that our holding in *Blackburn* was superseded by section 483 when the interest rate used in a contract is as great as the interest rate used for purposes of section 483(c)(1)(B). We do not think, however, that a section intended to increase the accuracy of income reporting should be interpreted as preventing respondent from accurately calculating the amount of a gift.

Since petitioners are not entitled to rely on the 6-percent interest rate used for purposes of section 483, we must decide whether respondent properly used an 11-percent rate. Petitioners have the burden of proving that respondent's determination is incorrect. Rule 142(a). Petitioners assert that in 1981 the average rate of interest charged on contracts for deed in the United States was 6 to 8 percent. They refer to Congressional testimony in which a senator asked "Are contracts for deed prevalent in the 6 to 8 percent range or something like that," and the Assistant Secretary of the Treasury for Tax Policy responded "Right." The off-hand nature of this answer does not give us much confidence in its evidentiary value. Petitioners also refer to Senate hearings in which an economist testified that the interest rate on contracts for deed in Minnesota averaged 6 to 8 percent. Petitioners argue that this evidence is not hearsay because, among other reasons, the economist's statements are more probative on the point than any other evidence which petitioners could procure through reasonable efforts. We disagree, because petitioners at a minimum could have brought in the economist as an expert witness who would have been subject to cross-examination. Petitioners also present an article with a graph that shows that interest rates on seller-financed real estate transactions were below Federal Land Bank rates in June 1981. We will not consider this graph because, among other reasons, a lower interest rate on seller-financed real estate transactions might be offset by a higher selling price. In fact, this possibility is suggested by the article that contains the graph. Petitioners have not shown that the market interest rate on loans similar to theirs was 6 to 8 percent.

Respondent asserts that the interest rate of 11 percent in the notice of deficiency was reasonable or perhaps too low. We are provided with several interest rate figures. In June 1981, the average prime rate was 20.03 percent, the average interest rate on conventional first mortgage loans for the purchase of a single family home was 14.12 percent for new purchases and 14.40 percent for existing home purchases, the interest rate on certain 3-month commercial paper was 16.13 percent, the interest rates on 1-year and 30-year United States Treasury obligations were 13.02 percent and 13.11 percent, respectively, and the Federal Land Bank of St. Paul interest rate was 10.75 percent. The lowest of these interest rates is the 10.75-percent rate of the Federal Land Bank of St. Paul. This rate is essentially equivalent to the 11-percent rate used by respondent. Given that all of the other interest rates are significantly higher, we hold that respondent correctly used an 11-percent interest rate to discount the contract payments.

Petitioners assert that respondent should not have discounted the contract payments over the 30-year term of the contract. They argue that it was unlikely that both petitioners would outlive the 30-year term of the contract, since both were in their mid-sixties when the contract was executed. Thus, it was likely that the purchasers would have to prepay a portion of the contract, shortening its term. However, petitioners presented no evidence regarding the amount of the expected prepayment. In the absence of this evidence the expected term of the contract cannot be determined. Accordingly, respondent correctly used the 30-year term for purposes of discounting the contract payments.

Decision will be entered under Rule 155.

Reviewed by the Court.

NIMS, CHABOT, PARKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, JACOBS, GERBER, WRIGHT, WELLS, RUWE, AND COLVIN, JJ., agree with the majority opinion.

PARR AND WHALEN, *JJ.*, dissent.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 90-2876	*	
Lester H. Krabbenhoft; Anna Krabbenhoft,	*	Order Denying Petition for Rehearing and Suggestion for Rehearing En Banc
Appellants,	*	
vs.	*	
Commissioner of Internal Revenue,	*	
Appellee.	*	

Appellant's petition for rehearing with suggestion for rehearing en banc has been considered by the court and is denied by reason of the lack of a majority of the active judges voting to rehear the case en banc.

The petition for rehearing is also ordered denied.

August 9, 1991

Order Entered at the Direction of the Court:

/s/ Michael E. Gans

Clerk, U.S. Court of Appeals, Eight Circuit

SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

(a) Amounts Constituting Interest. – For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) Total Unstated Interest. – For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, and amount equal to the excess of –

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of the payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

(c) Payments to Which Section Applies. –

(1) In general. – Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract –

(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

(B) under which, using a rate provided by regulations prescribed by the Secretary for purposes of this subparagraph, there is total unstated interest.

Any rate prescribed for determining whether there is total unstated interest for purposes of subparagraph (B) shall be at least one percentage point lower than the rate prescribed for purposes of subsection (b)(2).

(2) Treatment of evidence of indebtedness. – For purposes of this section, an evidence of indebtedness of the purchaser given in consideration for the sale or exchange of property shall not be considered a payment, and any payment due under such evidence of indebtedness shall be treated as due under the contract for the sale or exchange.

(d) Payments that are indefinite as to time, liability, or amount. – In the case of a contract for the sale or exchange of property under which the liability for, or the amount or due date of, any portion of a payment cannot be determined at the time of the sale or exchange, this section shall be separately applied to such portion as

if it (and any amount of interest attributable to such portion) were the only payments due under the contract; and such determinations of liability, amount, and due date shall be made at the time payment of such portion is made.

(e) Change in Terms of Contract. – If the liability for, or the amount or due date of, any payment (including interest) under a contract for the sale or exchange of property is changed, the "total unstated interest" under the contract shall be recomputed and allocated (with adjustment for prior interest (including unstated interest) payments) under regulations prescribed by the Secretary.

(f) Exceptions and Limitations. –

(1) Sales price of $3,000 or less. – This section shall not apply to any payment on account of the sale or exchange of property if it can be determined at the time of such sale or exchange that the sales price cannot exceed $3,000.

(2) Carrying charges. – In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be made without regard to this section if any such amounts are treated under section 163(b) as if they included interest.

(3) Treatment of seller. – In the case of the seller, the tax treatment of any amounts received on account of the sale or exchange of property shall be made without regard to this section if all of the gain, if any, on such sale or exchange would be considered as ordinary income.

(4) Sales or exchanges of patents. – This section shall not apply to any payments made

pursuant to a transfer described in section 1235(a) (relating to sale or exchange of patents).

(5) Annuities. – This section shall not apply to any amount the liability for which depends in whole or in part on the life expectancy of one or more individuals and which constitutes an amount received as an annuity to which section 72 applies.

Reg. § 1.483-1 Computation of interest on certain deferred payments.

(a) Computation of amount constituting interest – (1) General rule. For all purposes of the Internal Revenue Code, in the case of any contract for the sale or exchange of property, there shall be treated as interest as interest that part of a payment to which section 483 applies (see paragraph (b) of this section) which bears the same ratio to the amount of such payment as the total unstated interest (as defined in paragraph (c) of this section) under such contract bears to the total of the payments to which section 483 applies which are due under such contract. Thus, the amount to be treated as interest under section 483 is determined by multiplying each payment to which such section applies by a fraction, the numerator of which is the total unstated interest under the contract, and the denominator of which is the total of all the payments to which section 483 applies which are due under such contract. The effect of this ratio is to allocate the total unstated interest on a pro rata basis among the total payments to which section 483 applies. Accordingly, the

total amount to be treated as interest for a taxable year with respect to a contract under which there are payments which include unstated interest is an amount equal to the unstated interest allocated to the payments under the contract for such year plus any stated interest reportable under the contract for such year. See paragraph (b)(2) of this section for rules relating to allocation of contract price, payments, and stated interest; paragraph (e) of this section for rules relating to indefinite payments; paragraph (f) of this section for rules relating to changes in terms of contract; and paragraph (b) of § 1.483-2 for exceptions and limitations to the application of section 483.

Supreme Court, U.S.
FILED
DEC 27 1991
OFFICE OF THE CLERK

No. 91-750

In the Supreme Court of the United States

OCTOBER TERM, 1991

LESTER H. KRABBENHOFT and
ANNA KRABBENHOFT, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether Section 483 of the Internal Revenue Code relieves petitioners of the gift tax liability that otherwise would be imposed under Section 2512(b) for their below-market sale of real property to their children.

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In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-750

LESTER H. KRABBENHOFT and
ANNA KRABBENHOFT, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a) is reported at 939 F.2d 529. The opinion of the Tax Court (Pet. App. 16a-24a) is reported at 94 T.C. 887.

JURISDICTION

The judgment of the court of appeals was entered on June 27, 1991. A petition for rehearing and suggestion for rehearing en banc was denied on August 9, 1991 (Pet. App. 25a). The petition for a writ of certiorari was filed on November 7, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 483, 2501 and 2512 of the Internal Revenue Code (26 U.S.C.) are set forth at Appendix, *infra*, 1a-2a.

STATEMENT

1. Petitioners transferred two parcels of land to their sons on June 29, 1981. One parcel was conveyed as a gift. The other parcel was conveyed under a contract for deed with a purchase price of $400,000 to be paid in 30 annual installments, along with interest at six percent on the unpaid balance (Pet. 2; Pet. App. 2a). Petitioners filed gift tax returns reporting a gift tax liability for the donated parcel of land, but they reported no gift tax liability for the parcel conveyed by contract for deed (*ibid.*).

Section 2512(b) of the Internal Revenue Code provides that, when property is transferred for less than full consideration, "the amount by which the value of property exceeded the value of the consideration shall be deemed a gift." 26 U.S.C. 2512(b). The Commissioner issued notices of gift tax deficiency to petitioners, asserting that the difference between the value of the property they conveyed to their children by contract for deed ($443,400) and the present value of the payments due them under the contract ($252,642) constituted a gift subject to the gift tax (Pet. App. 2). The Commissioner determined the present value of the proceeds of the sale by applying an 11 percent discount rate to the payments required by the contract (*ibid.*).

2. Petitioners contested the Commissioner's determination of deficiencies in the Tax Court. They claimed that, under Section 483 of the Internal Revenue Code, the Commissioner was prohibited from valuing the payments due under the sale contract at less

than their face value. Section 483 imputes *interest income* to the seller of property under installment sales contracts when the contract provides for interest on the unpaid balance at less than the specified minimum rate of six percent (see note 2, *infra*). See 26 U.S.C. 483. Petitioners asserted that, because the interest rate specified in the contract for deed was sufficient to preclude the imputation of additional interest income to them under Section 483, the Commissioner also was precluded from treating the conveyance as a bargain sale for gift tax purposes under Section 2512(b) of the Code. In the alternative, petitioners maintained that the six percent interest rate specified in the contract for deed represented the prevailing market interest rate for installment sales of land and that the Commissioner had erred in using an 11 percent rate to calculate the present value of the deferred payments provided in the contract.

The Tax Court, in a reviewed opinion, entered decision for the Commissioner (Pet. App. 16a-24a). The court held that Section 483 applies only to imputed interest income and has no application to the valuation of property for gift tax purposes (*id.* at 20a-21a). The court also found that the Commissioner's use of an 11 percent discount rate to obtain the present value of the deferred payments was not erroneous (*id.* at 23a).

3. The court of appeals affirmed (Pet. App. 1a-15a). The court held that Section 483 does not affect the valuation of an installment sales contract for gift tax purposes, stating that "§ 483 is simply irrelevant to such a determination" (Pet. App. 10a). The court also affirmed the Tax Court's finding that petitioners failed to prove that the 11 percent discount rate used by the Commissioner to value their contract for gift tax purposes was incorrect (Pet. App. 12a).

ARGUMENT

The decision of the court of appeals is correct. Although the Seventh Circuit reached a contrary decision in *Ballard* v. *Commissioner*, 854 F.2d 185 (1988), there is no need for this Court to resolve the conflict between the circuits because the question presented in these cases has no continuing significance in view of recent amendments to the statutory scheme.

1. Section 2501(a) of the Internal Revenue Code imposes a gift tax on any transfer of property by gift. Section 2512(b) provides that, when property is transferred for less than an adequate and full consideration, the amount by which the fair market value of the property exceeds the value of the consideration received in return is deemed to be a gift. It has long been established that, in determining whether a transfer of property has effected a gift, the value of any promissory note issued as complete or partial consideration for the transfer must be taken into account at its fair market value, rather than its face value. See, *e.g.*, *Blackburn* v. *Commissioner*, 20 T.C. 204 (1953); *Estate of Berkman* v. *Commissioner*, 38 T.C.M. (CCH) 183 (1979); cf. *Mason v. United States*, 513 F.2d 25 (7th Cir. 1975).

In the present case, petitioners transferred real property worth approximately $400,000 to their sons, in exchange for their sons' agreement to pay them $400,000 in equal annual installments over a period of 30 years, along with interest at six percent on the unpaid balance. The Commissioner determined that the prevailing interest rate on similar transactions at the time petitioners conveyed the property was 11 percent and that, consequently, the present value of the deferred payments due petitioners under the installment sales contract was approximately $250,000.

The Commissioner concluded that petitioners had made a taxable gift to their children of the amount by which the value of the property transferred exceeded the present value of the deferred payments due under the sales contract.[1]

2. Although petitioners contended that the Commissioner was required by Section 483 of the Code to treat the face value of the deferred payments under the contract as the present value of those payments, the courts below correctly held that Section 483 has no application in determining the value of consideration for gift tax purposes under Section 2512(b) of the Code.

Section 483 was enacted in 1964 to curb a specific income tax avoidance problem. Prior to the enactment of Section 483, if the parties to a contract for the installment sale of a capital asset did not expressly provide for interest to be included in the deferred payments, the seller could treat the entire amount received (to the extent it exceeded his adjusted basis in the property) as capital gain, even though part of that amount represented interest income on deferred payments of principal. In this manner, interest income (taxable at higher ordinary income rates) was converted into capital gains (taxed at lower rates applicable to that type of income). Section 483 was enacted to prevent this specific manipulation of the income tax laws. See H.R. Rep. No. 749, 88th Cong., 1st Sess. 72 (1963); S. Rep. No. 830, 88th Cong., 2d Sess. 102 (1964).

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[1] The court of appeals and the Tax Court agreed that the Commissioner's use of an 11 percent interest rate to determine the present value of the deferred payments was proper (Pet. App. 12a, 23a). Petitioners do not seek review of this issue.

Section 483 solved this problem by providing, in general, that (i) if property is sold on an installment basis with part or all of the payments due more than one year after the date of the sale and (ii) there is no provision for interest on the deferred payments, or a provision for interest that is less than the specified minimum rate (the so-called "safe harbor" rate specified in the regulations), then an allocated part of each installment is to be treated as interest income rather than as part of the sales price. The specified minimum rate applicable under Section 483 in 1981 was six percent. 26 C.F.R. 1.483-1(g) (1981).

As the Tax Court and the Eighth Circuit correctly recognized, the fact that petitioners' contract for sale provided for interest on the deferred payments at six percent did not preclude the Commissioner from determining that petitioners had made a taxable gift under Section 2512(b) of the amount by which the value of the property conveyed exceeded the present value of the deferred payments due under the contract. Petitioners' use of the safe harbor rate of six percent served only to immunize them from the imputation of additional *interest income* under Section 483. It did not protect them from gift tax liability under the separate provisions of Section 2512 of the Code.[2]

3. In reaching the contrary conclusion in *Ballard* v. *Commissioner*, 854 F.2d at 188, the Seventh Cir-

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[2] This is evident from the language, as well as the history, of Section 483. The statute applies only to installment contracts that contain "total unstated interest." Section 483 (c)(1). A contract that provides for interest at or above the "safe harbor" rate established in the regulations, as did petitioners' contract, contains no "unstated interest" within the meaning of Section 483. It is therefore not subject to the provisions of that statute. See 26 U.S.C. 483(b), 483(c)(1).

cuit placed undue emphasis on the language in Section 483(a) which states that its provisions are applicable for the "purposes of this title" (26 U.S.C. 483(a)). The Seventh Circuit reasoned that because the term "title" refers to the entire Internal Revenue Code, which includes both Subtitle A (Income Taxes) and Subtitle B (Estate and Gift Taxes), Section 483 necessarily applies to gift tax calculations as well as interest income calculations. 854 F.2d at 188. As the court of appeals concluded in the present case (Pet. App. 8a), however, this reasoning "ignore[s] the simple fact that nothing in § 483 makes it relevant to valuation for gift tax purposes." Section 483 concerns imputing interest income; Section 2512(b) concerns valuation of property for gift tax purposes. There is neither a literal nor a substantive overlap between these two provisions. Moreover, nothing in the legislative history of Section 483 suggests that Congress intended that Section 483 would have any application in the gift tax area, much less that it would override the specific gift tax provisions of Section 2512(b).[3]

4. The issue presented in this case and in *Ballard* v. *Commissioner* has no continuing significance to ad-

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[3] Petitioners point to Section 483(g)—which provides a lower "safe harbor" interest rate for transfers of land between related parties—as evidence that Congress intended to protect the type of transaction at issue in this case from "adverse gift tax consequences" (Pet. App. 8). Nothing in Section 483(g) or its legislative history supports that reading. Section 483(g) was intended to provide *income tax* relief to individuals selling land to related parties, because Congress believed that it is unlikely that interest rates would be understated in land sales since a *buyer* would ordinarily prefer the payment to be deductible as interest rather than be capitalized as an overstated investment in real property. See Staff of Joint Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, 97th Cong., 2d Sess. 60 (Comm. Print 1981).

ministration of the tax laws. In the twenty-seven years that have elapsed since Section 483 was enacted, the interrelationship of Sections 483 and 2512 has been addressed in only two reported decisions. In 1984, Congress removed any lingering doubt as to the proper application of these statutes by enacting Section 7872 of the Code, 26 U.S.C. 7872.

Section 7872 provides a comprehensive scheme for the tax avoidance problems posed by the use of interest-free or below-market rate interest loans. See H.R. Rep. No. 432, 98th Cong., 2d Sess. Pt. 2, at 1370-1379 (1984); 1 S. Prt. No. 169, 98th Cong., 2d Sess. 474-485 (Comm. Print 1984). In general terms, Section 7872 provides, with respect to the gift tax, that the recipient of a loan has received a gift equal to the amount of the "foregone interest." 26 U.S.C. 7872(a). The term "foregone interest" is defined as the excess of the amount of interest that would have been payable at the applicable "Federal rate" over the amount of interest payable under the terms of the loan. 26 U.S.C. 7872(b)(2). In this statute, Congress has thus provided an objective method for valuing the gift portion of an interest free or below-market loan. At the same time, Congress established specified interest rates which, when utilized in a transaction, will preclude imposition of any additional gift tax liability.

Section 7872 codifies the approach taken by the Commissioner in this case and provides a comprehensive solution to the entire area of interest-free or below-market-rate loans.[4] In doing so, it has con-

[4] Although Section 7872(f)(8) provides that Section 7872 is not applicable to any loan to which Section 483 applies, Section 483 is applicable only to installment contracts for the sale of property that contain "total unstated interest." See

firmed that Section 483 has no application to valuations required for gift tax purposes.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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note 2, *supra*. Contracts that provide for interest at or above the safe harbor rate set forth in the regulations, as did petitioners' contract, by definition do not contain unstated interest and therefore are outside the scope of Section 483. See 26 U.S.C. 483(b) and (c)(1).

APPENDIX

26 U.S.C. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

(a) *Amounts Constituting Interest.*—For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) *Total Unstated Interest.*—For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which the section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of the payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

(c) *Payments to Which Section Applies.*—

(1) *In General.*—Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

(B) under which, using a rate provided by regulations prescribed by the Secretary for purposes of this subparagraph, there is total unstated interest.

Any rate prescribed for determining whether there is total unstated interest for purposes of subparagraph (B) shall be at least one percentage point lower than the rate prescribed for purposes of subsection (b)(2).

(2) *Treatment of evidence of indebtedness.*—For purposes of this section, an evidence of indebtedness of the purchaser given in consideration for the sale or exchange of property shall not be considered a payment, and any payment due under such evidence of indebtedness shall be treated as due under the contract for the sale or exchange.

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26 U.S.C. 2501. IMPOSITION OF TAX.

(a) *Taxable Transfers.*—

(1) *General rule.*—For the first calendar quarter of the calendar year 1971 and each calendar quarter thereafter a tax, computed as provided in section 2502, is hereby imposed on the transfer of property by gift during such calendar quarter by any individual, resident or nonresident.

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26 U.S.C. 2512. VALUATION OF GIFTS.

(a) If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

(b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar quarter.

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